Private equity: global money in Indian industry

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AS A SEPARATE ASSET CLASS, PRIVATE equity has grown remarkably over the past few years. Private equity funds attract huge amounts of capital from investors, including pension funds, insurance funds, universities, foundations and individuals who are looking for new investment avenues. This new asset class owes its success to strong global liquidity and economic stability. The growth of private equity has reached a strategic stage, and private equity now accounts for a significant portion of global mergers and acquisitions. Cash-rich and armed with cheap debt, private equity firms have spread their activities across the globe. They are deploying their funds to new geographical areas, and have diversified into technological companies and contemporary manufacturing industries.

India is emerging as an economic powerhouse. Its companies have shown that they have a great appetite for mergers and acquisitions, both domestically and globally. India is now on the priority list for all private equity funds. In the global tables listing M&A deals by value and volume, India was ranked 12th in 2006, and climbed to seventh position in the first three months of 2007. Private equity firms are actively supporting Indian corporates in their empire-building plans.

This benefits both sides. With strong growth prospects, Indian corporates can offer handsome yields to private equity funds without enhancing their debt burden. According to PricewaterhouseCoopers, private equity investments in India have fetched foreign investors an internal rate of return (IRR) of 25%-40% in recent years.

INTERESTING STATISTICS

ChrysCapital generated an IRR of more than 135% on the sale of its stake in Spectramind to Wipro. The successful IPOs of TV Today Network and NDTV also fetched handsome returns for their PE investors (GE Capital and ICICI Venture in the case of TV Today, and Fleming and JP Morgan in NDTV).

The biggest deal last year involved Idea Cellular, India's fifth-largest wireless operator, which raised $950m for a group of investors including Providence Equity Partners, ChrysCapital and Citigroup. Another deal saw Kohlberg Kravis Roberts paying $900m for 85% of Textronics Software.

The most profitable private equity deal in India to date has been Warburg Pincus's $300m bet in 1999 on Bharti Tele-Ventures, today India's largest mobile service provider, which it subsequently sold piecemeal over several years for $1.6bn. Returns on that scale have attracted the likes of Carlyle, Blackstone, Texas Pacific, KKR, Farallon, Temasek, General Atlantic and many others.

RISING TREND

Foreign direct investment (FDI) in India has been liberalised. The old Foreign Exchange Regulations Act has been scrapped and replaced by the Foreign Exchange Management Act (FEMA) – a modern and far more liberal piece of legislation. Today, the Indian venture capital/private equity industry is quite sophisticated. Its activities have more breadth and depth, and its players are adapting and creating new structures and instruments to suit the requirements of Indian corporates.

Some global private equity funds are increasingly favouring India over China. With a stable democracy, an abundance of English speakers and progressive government policies, India is well placed to challenge China's record in attracting FDI. There are already some indications of a shift in the movement of global money towards India.

According to Venture Intelligence, FDI in India rose to $3.2bn between April and June 2007, up from $1.9bn in the same period last year. There were 76 deals in the quarter, up from 67 in the same quarter last year. The financial services sector accounted for 15 deals worth about $1.3bn. The largest was a $767m investment by Carlyle Group and Citigroup in India's largest mortgage firm, Housing Development and Finance Corporation. Technology-related sectors had more than 25 deals, but they were worth only $550m. FDI in manufacturing has declined.

Private equity investment in India has more than tripled, from $2.26bn in 2005 to $7.46bn in 2006. It is expected to reach about $10bn in 2007.

Deals are now also significantly larger. There were 26 deals involving investments of over $50m in 2006, compared with just nine in 2005. Investments have spread far beyond the traditional sectors, such as telecoms and information technology. While the IT and the IT-enabled services industries accounted for almost one-fifth of all investments, amounting to approximately $1.5bn, manufacturing also pulled in almost $1bn. Financial services is emerging as the second most favourite sector after IT. The healthcare and life sciences industries are attracting substantial funding even though they are in a nascent stage. With massive infrastructure development taking place in India, engineering and construction have also attracted a great deal of investment.

Venture Intelligence's estimates do not include investments in real estate, which could be well in excess of $1bn, as only a part of that was invested in equity – the bulk was used to acquire physical assets. A spokesperson for Mumbai-based Asia Growth Capital at the Carlyle Group says: 'We're sector agnostic. Broadly we see two investment themes: one, the growth of outsourcing, whether IT, IT-enabled services, generic pharmaceuticals, clinical research, contract manufacturing, engineering and design or any other knowledge-based service; and two, the huge infrastructure and consumption needs this growth fuels.'

The industry now covers the entire spectrum of private equity products – seed funding, expansion capital, buyout financing, financing restructuring of companies and providing mezzanine capital across a variety of sectors.

THE OPPORTUNITY

This development comes at a time when small and medium enterprises (SMEs) in India are looking for an alternative method of fundraising. While the UK has the Alternative Investment Market, in India private equity can act as an alternative source of fundraising for SMEs. Private equity investment can help SMEs get the much-needed resources for their future expansion. These businesses can also leverage the expertise of the private equity funds to multiply operational performance.This will enable them to grow at an organic pace, mature into large organisations and access global markets. Indian legislation has already incorporated corporate governance and financial reporting systems that are on a par with global standards. This will make private equity funds confident that they can expect a quality performance from local businesses.

However, some industry experts feel that the full potential of private equity investment in India has not yet been unleashed. 'India Inc' is ready and geared for growth. All it needs is global money to expand. Today India has:

a) an abundance of entrepreneurial talent;
b) the largest English-speaking population in the world;
c) a high number of young people with university degrees;
d) political stability (all the major political parties have a common agenda on economic growth) and a progressive government;
e) a growing middle class with an appetite for a western lifestyle; and
f) high levels of self-confidence.

This is a potentially explosive combination. Private equity funds may be the catalyst for a frenzied period of economic activity.

A recent survey by Venture Intelligence on the impact of private equity finance on the economy bears this out. It revealed that 'about 96% of top executives at private equity/venture capital-backed firms believe that without PE/VC financing their companies would not have existed or would have developed slower'. A senior partner at private equity investment group Apax Partners, which advises funds totalling $20bn, and launched its India operation in New Delhi last November, adds: 'The drivers of private equity investment in the Indian market include consolidation in fragmented industries, international expansion, increasing domestic market spend and continued growth in value-added services.'

There have been some hiccups though. For example, the Indian government has issued new guidelines on the overseas issue of preferential shares – a tool that can be used to arrive at the correct valuation of a company to facilitate the structuring of a deal. The guidelines were intended to restrict the flow of money into the Indian real estate sector, but have had the effect of restricting the capability of private equity players to structure deals.

In spite of this, the Indian private equity market is bullish about its growth prospects. The pharma/biotech, real estate/construction, infrastructure, manufacturing, retail, IT and IT-related services sectors all offer good opportunities. Overall, there is a broad consensus among private equity players that India is a suitable destination offering great opportunities for investment. Experts say that realising the huge potential in this country is only a matter of time.

ENTRY STRATEGIES

A private equity fund can formally enter the Indian market by setting up as a venture capital fund. Private equity can also play significant role on an individual basis. A private equity fund can invest directly into any emerging company under FDI guidelines. Incorporated entities and foreign nationals can invest into Indian domestic companies without government approval.

The activities of venture capital funds are regulated by formal legislation under the aegis of the Securities and Exchange Board of India (SEBI). FDI by incorporated bodies and foreign nationals is regulated by the Reserve Bank of India (RBI) under FEMA.

In India venture capital plays a vital role in the development and growth of innovative entrepreneurships. In the past, venture capital activity was undertaken by financial institutions, such as the Industrial Development Bank of India (IDBI) and the Industrial Credit and Investment Corporation of India (ICICI), and state financial corporations. These institutions promoted entities in the private sector with debt as a funding instrument.

For a long time, funds raised from the public were used as a source of venture capital. However, this source depended a lot on market vagaries. And with the minimum paid-up capital requirements being raised for listing at the stock exchanges, it became difficult for smaller firms with viable projects to raise funds from the public. In India, the need for venture capital was recognised in the government's seventh five-year plan and the long-term fiscal policy.

In 1973 a committee on the development of SMEs highlighted the need for faster venture capital as a source of funding for new entrepreneurs and technology. Venture capital financing really started in India in 1988, with the formation of Technology Development and Information Company of India Ltd (TDICI) – promoted by ICICI and UTI Bank. The first private venture capital fund (Credit Capital Venture Fund) was sponsored by Credit Capital Finance Corporation (CFC) and promoted by the Bank of India, the Asian

Development Bank and the Commonwealth Development Corporation. At the same time, Gujarat Venture Finance Ltd and APIDC Venture Capital Ltd were started by state-level financial institutions. The sources of these funds were financial institutions, foreign institutional investors, pension funds and high net-worth individuals.

The private equity industry attained formal status in 1998, when SEBI set up its committee on the venture capital industry. This committee laid down clear guidelines for venture capital funds, which opened up the industry for private players. In 1998 only eight domestic venture capital funds were registered with SEBI. By the turn of the century, 19 funds were registered, a number of which were foreign. SEBI now regulates venture capital business through the Securities and Exchange Board of India (Venture Capital Funds) Regulations, 1996, as amended in 2006.

There are four types of organised or institutional venture capital funds:

1) venture capital funds set up by angel investors, ie high-net-worth individuals;

2) venture capital subsidiaries of corporations and private venture capital firms/funds;

3) venture capital subsidiaries established by major corporations, commercial bank holding companies and other financial institutions; and

4) venture capital funds promoted by government agencies.

METHODS OF VENTURE FINANCING

Venture capital is typically available in three forms in India:

Equity: All venture capital funds in India provide equity, but generally their contribution does not exceed 49% of the total equity capital. Thus, the effective control and majority ownership of the firm remains with the entrepreneur. They buy shares of an enterprise with an intention to ultimately sell them off to make capital gains.

Conditional loan: A conditional loan is repayable in the form of a royalty after the venture starts generating sales. No interest is paid on such loans. In India, venture capital funds charge royalties ranging between 2% and 15%. The actual rate depends on other factors of the venture, such as its gestation period, cost-flow patterns and risk.

Income note: An income note is a hybrid security which combines the features of both a conventional loan and a conditional loan. The entrepreneur has to pay both interest and royalty on sales, but at substantially lower rates.

However, a few venture capitalists, particularly in the private sector, have started introducing innovative financial securities, such as participating debentures.

LEGISLATION

FEMA governs foreign investments in India. The issue of shares by an Indian company is governed by the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000, as amended from time to time. These Regulations provide for the fresh issue of shares as well as the transfer of shares from residents to non-residents, including the acquisition of shares in an existing company under the automatic route subject to sectoral policy on FDI.

All investments made under these Regulations are fully repatriable, subject to the payment of appropriate taxes. Dividends, sales proceeds and distributions made by a company on winding up can be repatriated without RBI approval.

The Department of Industrial Policy and Promotion is the monitoring authority that issues FDI guidelines. FDI policy is quite liberal. FDI is prohibited in just four sectors: retail trading (except single brand product retailing), atomic energy, lottery business and gambling/betting.

Prior government approval for FDI is only required where a foreign partner already has a prior venture (in all activities/sectors except IT) or where more than 24% foreign equity is proposed to be inducted for the manufacture of items reserved for the small-scale sector. There are a small number of sector-specific FDI limitations under the automatic route:

- 26% FDI is allowed in defence production, insurance, petrochemicals refining, and the publishing of newspapers and periodicals dealing with news and current affairs;
- 49% FDI is allowed in air transport services (100% for non-resident Indian (NRI) investment), asset reconstruction companies, telecoms and companies investing in infrastructure or the services sector;
- 51% FDI is allowed in single brand product retailing;
- FDI limits in broadcasting are 20% for FM Radio (this also applies to Foreign Institutional Investment (FII)), 49% for cable networks, 'direct-to-home' and setting up hardware facilities, 26% for uplinking a news and current affairs TV channel, and 100% for uplinking a non-news and current affairs TV channel;
- 74% FDI is allowed in atomic minerals, banking (private sector) as well as satellites establishment and operation.

All other sectors/activities qualify for 100% FDI.

Very soon this sector-specific list will disappear. The Indian rupee will soon be fully convertible, and global private equity players will be able to take advantage of liberalised regulations.

CONCLUSION

Globally, private equity has delivered higher returns over a longer time frame. For India, the private equity industry has produced more than average returns, and massive growth in private equity investment in almost all sectors of the Indian economy is expected. Conservative estimates show that private equity investment in India is set to exceed $50bn in the next five years. This could rise if the process of privatisation and liberalisation is speeded up. India will offer an excellent opportunity to global private equity players over the next decade.